

Talbot County, Maryland

Full Rating Report

Ratings

Long-Term Issuer Default Rating AAA

Outstanding Debt

General Obligation Public Improvement Bonds AAA
Public Improvement Refunding Bonds AAA

Rating Outlook

Stable

Analytical Conclusion: The 'AAA' IDR and GO ratings reflect the county's very low long-term liability burden and associated fixed carrying costs that are a minimal percent of spending. The rating also reflects healthy reserves that provide exceptionally strong gap-closing capacity to address an economic downturn given the county's high level of budget flexibility.

Key Rating Drivers

Economic Resource Base: The county is located on the western shore of the DelMarVa Peninsula, about 50 miles east of Washington, D.C. across the Chesapeake Bay. The estimated 2015 population of 37,512 is down slightly from the 2010 Census level. The county is rural and its economy largely driven by tourism, with a significant second home presence and a high level of income tax revenue concentration.

Revenue Framework: 'aa' factor assessment. Fitch expects general fund revenues, primarily derived from property and local income taxes, to continue to increase slowly, along with inflation. The income tax base is concentrated in an unusual level of high income earners. The county's independent ability to raise operating revenues under charter and statutory limits provides an allowable revenue increase that Fitch believes is substantial in relation to a normal cyclical decline.

Expenditure Framework: 'aa' factor assessment. The county's spending obligations are primarily associated with its schools and public safety. Any reduction to education spending without enrollment decline requires approval from the state, limiting flexibility. However, other fixed carrying costs related to debt, pensions and OPEB are very limited. County employees do not collectively bargain and management had success controlling spending through headcount reductions in the downturn.

Long-Term Liability Burden: 'aaa' factor assessment. The long-term liability burden is very low at about 3% of personal income. Debt levels are expected to remain low given the county's limited capital needs. The net pension liability for retiree benefits is very small despite the low ratio of assets to liabilities of the state-wide cost-sharing plan.

Operating Performance: 'aaa' factor assessment. Fitch's assessment of the county's operating performance reflects its commitment to maintaining sound reserves over time, which cushions it against risk associated with a volatile revenue base in an economic downturn. Revenue-raising capacity and expenditure flexibility contribute to the county's overall financial resilience.

Rating Sensitivities

Maintenance of Reserves: Based on the county's history of timely revenue enhancements, Fitch expects the maintenance of a reserve position sufficient to address revenue risk at the current rating level throughout the economic cycle.

Analysts

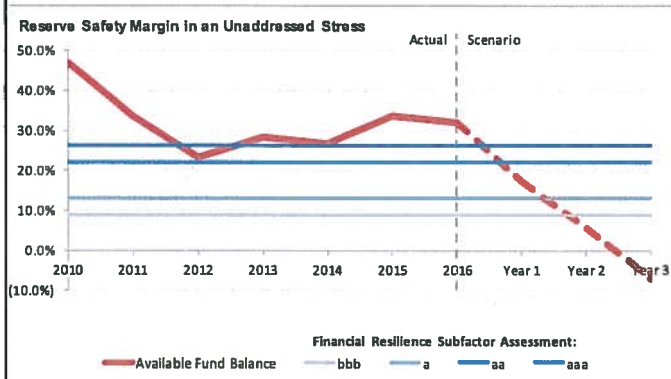
Parker Montgomery
+1 212 908-0356
parker.montgomery@fitchratings.com

Evette Caze
+1 212 908-0376
evette.caze@fitchratings.com

Talbot County (MD)

Scenario Analysis

v 1.10 2016/06/22



Analyst Interpretation of Scenario Results:

Following several years of operating deficits due to weak revenue performance during the previous recession that spent down reserves to 23% (or about half of the pre-recession level), the county prudently adjusted both revenues and expenses to regain structural balance. These efforts resulted in surplus operations each for the last four fiscal years. The county's formal policy is 15% of general fund expenditures, but Fitch expects the total reserve cushion to be maintained at higher levels.

Fitch's 'aa' assessment of the county's financial resilience is based on the combined strength of its fund balance position, expenditure flexibility and ability to adjust revenues through policy action compared to its historically very volatile revenues. The county annually increases the property tax rate by the full amount allowed under the county charter limit and also increased the local income tax rate in fiscal 2013 from 2.25% to 2.4%. Both tax rates remain among the lowest in the state. The county responded with expenditure controls including the use of layoffs, pay freezes and furloughs. Fitch believes that a similar use of fund balance would occur in a potential stress scenario going forward in addition to revenue modifications, though practically this could be somewhat limited and the county council has expressed its intention to maintain low tax rates.

Scenario Parameters:

GDP Assumption (% Change)
Expenditure Assumption (% Change)
Revenue Output (% Change)
Inherent Budget Flexibility

	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(8.8%)	(2.2%)	4.4%
Inherent Budget Flexibility	High		

Revenues, Expenditures, and Fund Balance	Actuals							Scenario Output		
	2010	2011	2012	2013	2014	2015	2016	Year 1	Year 2	Year 3
Total Revenues	62,074	61,255	63,591	70,240	77,016	78,874	79,199	72,234	70,647	73,755
% Change in Revenues	-	(1.3%)	3.8%	10.5%	9.6%	2.4%	0.4%	(8.8%)	(2.2%)	4.4%
Total Expenditures	67,850	69,331	71,052	67,919	75,484	73,859	78,476	80,045	81,646	83,279
% Change in Expenditures	-	2.2%	2.5%	(4.4%)	11.1%	(2.2%)	6.3%	2.0%	2.0%	2.0%
Transfers In and Other Sources	-	12,840	1,000	850	2,047	-	16,746	67	66	69
Transfers Out and Other Uses	2,414	13,886	575	535	2,255	622	17,146	1,078	1,099	1,121
Net Transfers	(2,414)	(1,046)	425	315	(208)	(622)	(400)	(1,010)	(1,033)	(1,053)
Bond Proceeds and Other One-Time Uses	-	12,651	-	-	-	-	16,411	-	-	-
Net Operating Surplus(+)/Deficit(-) After Transfers	(8,190)	(9,122)	(7,036)	2,636	1,324	4,393	323	(8,822)	(12,033)	(10,576)
Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out)	(11.7%)	(12.9%)	(9.8%)	3.9%	1.7%	5.9%	0.4%	(9.0%)	(14.5%)	(12.5%)
Unrestricted/Unreserved Fund Balance (General Fund)	32,941	23,867	16,793	19,380	20,772	25,034	25,479	16,657	4,624	(5,952)
Other Available Funds (Analyst Input)	-	-	-	-	-	-	-	-	-	-
Combined Available Funds Balance (GF + Analyst Input)	32,941	23,867	16,793	19,380	20,772	25,034	25,479	16,657	4,624	(5,952)
Combined Available Fund Bal. (% of Expend. and Transfers Out)	46.9%	33.8%	23.4%	28.3%	26.7%	33.6%	32.2%	17.1%	5.6%	(7.1%)
Reserve Safety Margins	Inherent Budget Flexibility									
	Minimal		Limited		Midrange			High	Superior	
Reserve Safety Margin (aaa)	140.7%		70.4%		44.0%			26.4%	17.6%	
Reserve Safety Margin (aa)	105.5%		52.8%		35.2%			22.0%	13.2%	
Reserve Safety Margin (a)	70.4%		35.2%		22.0%			13.2%	8.8%	
Reserve Safety Margin (bbb)	26.4%		17.6%		13.2%			8.8%	4.4%	

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AAA	Affirmed	Stable	2/01/17
AAA	Revised	Stable	4/30/10
AA+	Assigned	Stable	2/01/06

Credit Profile

The county is predominantly rural, with farmland comprising a majority its area. While agriculture is economically important, the county's main attraction is its 600 miles of shoreline. The leisure and hospitality industries represent an important share of the employment base. The shoreline is a popular retiree destination and attractive second home location for the large number of wealthy individuals in the greater Washington Metro region.

Management indicates the high level of second home ownership leaves the county more vulnerable to housing price volatility. The county's tax base has decreased in each of the last five fiscal years. Zillow reports average home values of about \$270,000 are only slightly above the 2012 trough and not likely to recover to the \$350,000 pre-recession peak in the foreseeable future. Area incomes, as measured by local income tax receipts, were also significantly hit during the Great Recession, providing additional stress on the county's finances discussed in the revenue framework below. Wealth metrics are above average compared to the state and nation.

In addition to hospitality and tourism, healthcare is another important economic sector as evidenced by Shore Regional Health, a member of the University of Maryland Medical System, accounting for about 10% of county employment. Fitch believes that the long-term prospects for the facility are positive, as University of Maryland Shore Medical Center at Easton serves an important regional need and continues to expand its operations. Employment in the county has increased steadily since 2009 but remains below pre-recession levels. Unemployment continues to decline along the lines of the state and national levels. The county's sizable and growing retiree population has largely driven the economic improvement.

Revenue Framework

Property tax is the largest revenue category at just under half of general fund revenues, which is followed by the local income tax at about a third of revenues. Other local taxes such as the recordation and accommodation taxes account for an additional 15% of revenues.

Income taxes are a higher percentage of revenues than is true for most Maryland counties. This is partially due to the very low tax environment compared to the rest of the state, which provides incentive for high income earners with second homes in the county to declare their income in the county. Talbot County's share of income tax revenue from taxpayers with over \$500,000 in Maryland Adjusted Gross Income was nearly twice the statewide average at 32% of income tax revenues in fiscal 2015, and high-income taxpayers had an average taxable income that was the highest in the state at \$1.4 million in fiscal 2010 according to information from the state's comptroller. Fitch believes this concentration risk contributed to very volatile general fund revenues during the previous recession.

On average general fund revenues increased behind inflation over the decade ending in fiscal 2016 despite policy action to increase tax rates on both property and income. The housing market was particularly slow to recover in the county due to the high percentage of second homes in waterfront communities that have not returned to pre-recessionary values. The county's assessed values (AV) have declined for the past five consecutive fiscal years; the county reassesses a third of the county annually. Fiscal 2017 AV is estimated to see a return to slight growth. Fitch expects continued slow growth overall and continued volatility in income tax receipts.

Fitch believes the county maintains substantial independent ability to raise revenues compared to the level of historical volatility. Since 1998 the county's charter has statutorily limited the increase of revenues derived from property taxes to the lesser of 2% or CPI growth. The

Related Research

Fitch Affirms Talbot County, MD's IDR and GOs at 'AAA'; Outlook Stable (February 2017)

Related Criteria

U.S. Tax-Supported Rating Criteria (April 2016)

county adjusts the property tax rate to take advantage of the full increase allowed under the limit each year. The county's property tax rate remains the lowest for any county in the state. The county has also applied its ability to increase the levy above the charter limit due to an educational supplement exemption as recently as fiscal 2017 and fiscal 2013 before that.

The county's main source of legal ability to raise revenues is from its room under the state's income tax cap. The county's current rate is 2.4%, and Fitch estimates the county could increase income tax revenues by 33%, or \$8.8 million, by raising the income tax rates to the legal cap of 3.2%. The room under the income tax cap alone has potential to generate more than the revenue decline depicted by a moderate economic downturn scenario. The educational supplement exemption under the charter levy limit and the ability to increase various other taxes and fees provide additional coverage of the modeled revenue stress.

Expenditure Framework

Education is the county's primary spending category at just over half of general fund expenditures, followed by public safety at 21% of spending. Like many local governments, a large majority of the budget is devoted to employee payroll related to service delivery. According to the state maintenance of effort mandate, education spending is tied to enrollment and cannot decline from year to year without approval from the state, which somewhat limits spending flexibility.

The county's spending demands are expected to continue to grow steadily. Fitch believes spending growth will likely outpace the slow revenue growth prospects without policy action to adjust revenues.

Otherwise, fixed carrying costs for pension, debt service and OPEB spending are very minimal at just under 5% of spending. This includes costs associated with not only the county's general pension plan, but also the normal cost of the board of education employees' pension, which counties in Maryland are required to pay. The county pays the full pension contributions required by statute, but these contributions do not meet the actuarially determined contribution (ADC) at the system-wide level, which Fitch believes will pressure pension costs going forward. System-wide, the employees' plan and the teachers' plan paid 84% and 90% of the ADC for fiscal 2015, respectively. The county consistently pays OPEB above the actuarially calculated level.

County employees do not participate in collective bargaining, which provides management with broad legal control over workforce rules and employee wages and benefits. Management was successful achieving cost savings during the recession by reducing its headcount by about 10%. Overall headcount remains below the pre-recession levels and Fitch believes the ability to achieve a significant amount of further expenditure savings from employee reduction may be constrained by the amount cuts would impact the current level of service delivery. Public safety is the only department that did not sustain cuts and represents the largest portion of headcount.

Long-Term Liability Burden

The county's long-term liability burden is very low at just over 3% of personal income. A little under half of this metric is the direct debt of the county (\$31 million), which is unlikely to increase significantly in the near term. The county rapidly pays down existing debt and does not currently have plans to issue new debt. The capital improvement plan does have a \$30 million project for schools that is in early discussions regarding fund sources, which could ultimately include grants and some level of debt issuance.

Long-term liabilities related to defined benefits pensions are provided to employees through the State of Maryland Employees Retirement and Pension System (SMERPS). The net pension liability (NPL) for the county's portion of the system-wide liability is less than 1% of personal income, despite the plan containing assets that cover only about 65% of liabilities at Fitch's 7% investment return assumption.

Operating Performance

Following several years of operating deficits due to weak revenue performance during the previous recession that spent down reserves to 23% (or about half of the pre-recession level), the county prudently adjusted both revenues and expenses to regain structural balance. For details, see the Scenario Analysis on page 2.

The general fund unrestricted fund balance in fiscal 2016 was roughly \$25.5 million, or 32% of spending. The fiscal 2017 budget includes a \$2.5 million appropriation of fund balance, which was slightly larger than the \$1.3 million appropriation in the previous year's budget. The budget includes \$4 million, or 5% of spending, for one-time capital outlays as the county continues to catch up to previously postponed capital projects. While no formal plan has been implemented, management plans to continue to rebuild fund balances drawn down during the recession.

The county also held roughly \$10 million in committed reserves in a capital projects fund at year-end 2016 (comprised of prior surpluses from the general fund). These reserves can be used with council approval for general fund purposes, adding to operational flexibility.

Fitch views the county's policy to pre-fund the OPEB liability favorably. The county maintains over \$10 million in the OPEB trust, or 13% of fiscal 2016 general fund spending, which the county could utilize to help cover the cost of annual retiree health obligations.

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